SUPREME COURT, U. S.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 735

THE BUSINESS DEVELOPMENT CORPORATION OF NORTH CAROLINA, *Petitioner*,

v.

UNITED STATES OF AMERICA, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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Petitioner prays that a Writ of Certiorari issue to review a judgment of the United States Court of Appeals for the Fourth Circuit.

OPINION BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit is reported at —— F.2d ——, 26 AFTR 2d 70-5042 (the opinion is set out in full in Appendix, infra)

JURISDICTION

The judgment of the United States Court of Appeals was entered June 24, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

I. Whether the Court below applied the proper test as to what constitutes proof of reasonableness of a reserve for bad debts since its decision disregards factors which have been considered to be material by other federal appellate courts and is in conflict with the test applied by such courts.

II. Whether the Court properly and correctly construed the scope of the discretion vested in the Commissioner of Internal Revenue under the statute which provides for the deduction of a "reasonable" addition to a bad debt reserve, since the decisions of various federal courts are so inconsistent as to leave the intent and meaning of such statute in a state of confusion.

III. Whether the Court below, in deciding that the respondent's motion to set aside the jury's verdict in favor of the petitioner should have been granted, merely substituted its decision for that of the jury and thereby denied the petitioner of its right to trial by jury in violation of Amendment VII, United States Constitution.

IV. Whether the Court below, in approving the determination of the Commissioner of Internal Revenue that the petitioner was not entitled to deductions for additions made to its reserve for bad debts in 1963 and 1964, approved an exer-

cise of discretion by the Commissioner which results in a double standard for similarly situated taxpayers, in that the Commissioner grants federally chartered Small Business Investment Companies more favorable treatment than their state chartered counterparts.

V. Whether, in determining what constitutes the allowable addition to a reserve for bad debts for a taxpayer engaged in a new type of business with no actual past experience, the limitation of consideration to the past loss record of said business to the exclusion of other factors, results in a gross miscarriage of justice.

CONSTITUTIONAL PROVISION AND STATUTE INVOLVED

The Constitutional provision involved is Amendment VII, which is as follows:

> "In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury shall be otherwise reexamined in any court of the United States, than according to the rules of the common law."

The statutory provision involved is Section 166(c) of the Internal Revenue Code of 1954, and is as follows:

> "*Section 166. Bad Debts*
>
> . . . .
>
> (c) *Reserve for Bad Debts.* In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts."

STATEMENT OF THE CASE

The Business Development Corporation of North Carolina (hereinafter referred to as BDC), was incorporated in 1955 under special North Carolina enabling legislation. (R. 15)*. Its purpose was to stimulate economic development within North Carolina by providing a source from which parties who wished to start a new business or expand an existing business could borrow funds when they could not obtain financing from conventional sources. (R. 27-28). (Both the enabling legislation and BDC's Charter required that, as a prerequisite to obtaining a loan from BDC, a borrower had to first establish that he had been denied a loan by a conventional lending agency). (R. 17, 31).

When BDC was organized, the concept of a state business development corporation to promote economic development was new, the first such corporation having been organized in Maine about 1950. BDC was the first corporation of its type organized in the South. (R. 28-29, 51). From its organization to the end of the period herein involved it had operated only in a period of continuing prosperity. (R. 69, 101).

During the period beginning with its commencement of operations in April, 1956, and ending December 31, 1964, BDC made 145 loans in the total amount of $18,929,600, with the smallest loan being $2,000, the largest $500,000 and the average $175,000. Initially, BDC required the loans to be repaid within 10 years; however, the maximum repayment term was later extended to 15 years. (R. 57-58). When compared to commercial bank loans, BDC's loans were marginal, of substandard quality, and involved greater risk of loss. (R. 69, 109, 138). The term for repayment was longer than for

* Such references are to pages in the "Appendix".

similar loans by commercial banks; the borrowers were untried; and, in the event of a forced sale, the value of the collateral was questionable. (R. 69-70, 74, 100-101).

For its 1963 and 1964 taxable years BDC kept its books and filed its federal income tax returns on the accrual basis. (R. 15). It established a reserve to account for possible losses on its outstanding loans, and for the years from 1956 through 1962 made additions to its loss reserve account in the total amount of $318,387.58. It had no losses during this period, but had outstanding loans receivable totaling $8,490,336 at the end of 1962. (R. 17). During 1963 and 1964 BDC added the amounts of $95,000 and $120,000, respectively, to its loan loss reserve, sustained losses in the amounts of $28,037.72 and $23,015.66, respectively, which it charged to its loan loss reserve, and increased its outstanding loans so that it had outstanding loans receivable totaling $9,332,073 at the end of 1963 and $9,552,759 at the end of 1964. (R. 17). The amounts added in 1963 and 1964 were considered by members of BDC's executive committee to be reasonable additions to its loan loss reserve (R. 72-76, 99-101, 118-121, 138-139).

The enabling legislation pursuant to which BDC was established provides that its affairs shall be subject to examination by the Commissioner of Banks of North Carolina, and such examinations have been made about once every two years. (R. 106). In the examination reports the Commissioner of Banks constantly reminded BDC that sufficient reserves should be set up to take care of potential losses which, in his judgment, would be several times greater than those of commercial banks under similar circumstances. (R. 111-112). The Commissioner's staff generally felt that BDC's loss reserve should not be less than 10% of its total outstanding loans. (R. 111).

After the addition to its loan loss reserve of $95,000 in 1963 and $120,000 in 1964, the reserve at the end of each year was between 4% and 5% of the amount of BDC's total outstanding loans. (R. 19). If no amount had been added to the reserve in either of said years, the balance in the reserve account at the end of 1963 would have been 3.1% of its total outstanding loans and at the end of 1964 would have been 2.8% of its total outstanding loans. (R. 60-61).

On its federal income tax returns for 1963 and 1964 BDC claimed deductions for the amounts of $95,000 and $120,000, respectively, which it added to its loan loss reserve in such years. (R. 17).

The Commissioner of Internal Revenue disallowed in full the deductions claimed by BDC for additions to its loan loss reserve in 1963 and 1964 (R. 16). As a result, deficiencies and interest were assessed against and paid by BDC. (R. 16). Claims for refund were timely filed and disallowed. (R. 16-17).

Suit was subsequently instituted to recover the amounts claimed; and, after the presentation of evidence was concluded, the matter was submitted to a jury, which answered four special interrogatories. (R. 152-153). Upon the basis of the jury verdict judgment was entered in BDC's favor in the total principal amount of $128,303.67, plus interest. (R. 38-39). Thereafter, the Respondent made a motion for judgment notwithstanding the verdict or, in the alternative, for a new trial. (R. 40-41). The District Court denied such motion and the Respondent appealed to the United States Court of Appeals for the Fourth Circuit. (R. 42-43). The Court of Appeals reversed the District Court and ordered judgment to be entered for the Respondent. (Appendix, 4a, infra).

REASONS WHY THE WRIT SHOULD BE GRANTED

I. IN MAKING ITS DETERMINATION AS TO WHAT CONSTITUTES PROOF OF REASONABLENESS OF A RESERVE FOR BAD DEBTS, THE COURT BELOW EMPLOYED AN IMPROPER STANDARD BY REFUSING TO TAKE INTO CONSIDERATION FACTORS WHICH HAVE BEEN HELD BY OTHER FEDERAL APPELLATE COURTS TO BE PROPER FOR CONSIDERATION IN MAKING SUCH A DETERMINATION, AND ITS DECISION IS IN CONFLICT WITH ANOTHER FEDERAL APPELLATE COURT.

(a) Factors Proper for Consideration in Determining What Constitutes Proof of Reasonableness.

The standard test for computing a reasonable addition to the bad debt reserve, cited by many courts, is set out in *Merten's Law of Federal Income Taxation*, Section 30.73. (Zimet and Ness Revision, 1969), and is as follows:

> "What is a reasonable addition to a bad debt reserve depends upon the nature of the business, general business conditions, past experience in collecting accounts and bad debts, the amount of the existing reserve, and other material factors."

In the present case, the court below relied solely upon the past actual loss experience of the petitioner in holding that its reserves were adequate without the additions herein involved. (Appendix 7a). It cited *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F.2d 495 (4th Cir. 1960), to the effect that the purpose of the reserve is to charge the loss against the period in which it was actually incurred. It then stated that since the losses experienced to the end of 1964 were only $51,053.38 it was evident that the reserve existing at the beginning of 1963 was "generously adequate" without the 1963 and 1964 additions. (Appendix 7a). What the court did not consider was that losses which BDC might incur ten or

fifteen years later could relate to loans outstanding during 1963 or 1964.

The Fifth Circuit has stated that a reasonable addition to a reserve for bad debts is that amount necessary to bring the balance in the reserve to an amount which can be reasonably expected to cover anticipated losses with respect to debts outstanding at the end of the year. *Dixie Furniture Company* v. *Commissioner*, 390 F.2d 139 (5th Cir. 1968). The Ninth Circuit has held that evidence of reasonableness includes testimony relative to "the substantial risk incurred by a mortgagee who requires only a small down payment, a possible dip in the economy, a possible change in the neighborhood which would cause a decline in property values, expenses incident to foreclosure, the likelihood that a purchaser with small equity will fail to maintain the property and the slender market value, if any, of collateral share accounts during the early years of the loans which they secure." *Bolling* v. *Commissioner*, 357 F.2d 3, 10 (8th Cir. 1966). BDC presented testimony relative to similar matters as they related to its situation, all of which the jury heard and weighed in making its decision. These factors were disregarded by the court below, for its decision was in effect that there was no evidence which, as a matter of law, could support a jury verdict. As a result, it failed to apply the proper standard in making its determination.

The application of an improper standard in reviewing evidence and in examining the judgment rendered on the jury's verdict constitutes a proper basis for certiorari. *Scutilles* v. *Inter-Caribbean Shipping Corporation*, 361 U.S. 107, 80 S.Ct. 173, 4 L.Ed.2. 142 (1959).

(b) Conflict Between Circuits.

The First Circuit, in *Rhode Island Hospital Trust Co.* v. *Commissioner*, 29 F.2d 339 (1st Cir. 1928), considered a case in which the taxpayer made additions to its reserve for bad debts and the Board of Tax Appeals refused to allow such additions to said reserve for the reason that:

> "The evidence adduced shows that in setting up its reserve for bad debts and in making additions thereto the petitioner apparently resorted to guesswork. There is no evidence with respect to its experience as to losses over a period of years, upon which a reasonable reserve might be predicated." 8 B.T.A. 555 at 559

On appeal, the First Circuit held that such a ruling could not be sustained. It then reviewed the evidence presented by the taxpayer's witnesses, primarily its president, as to why the bank's officials believed such additions to be necessary, and held as follows:

> "The stated grounds for the action of the executive officials of this bank in increasing their reserve for bad debts—and thus decreasing the showing of profits applicable to dividends—is highly persuasive, if not entirely conclusive. To characterize this clear and cogent statement of the grounds on which experienced bankers limited their profits in the interest of safety, as 'guesswork', because reasonably anticipated losses were not ascertainable by mathematical calculation, is a position which this court declines to adopt. There is in this record no atmosphere of tax-dodging. While the honest judgment of bank officials as to the amount of profits made does not appear to be expressly made by statute prima facie evidence for profits-tax purposes, it is certainly, in the absence of any indication of a tax-dodging intent, to be given very substantial, if not controlling, weight. Plainly, such conservative action by

officials, having obviously fully adequate motives to regard loans made by themselves as good, should not be lightly overruled by any governmental authorities. To hold, as the Board of Tax Appeals apparently did hold, that the evidence did not warrant the Commissioner in exercising discretion favorable to the bank's claim, because there was 'no evidence with respect to its experience as to losses over a period of years upon which a reasonable reserve might be predicated,' was, as matter of law, wrong." 29 F.2d at 342

The action taken by the Fourth Circuit in the present case coincides exactly with the position taken by the Board of Tax Appeals in *Rhode Island Hospital Trust Co.*, and is therefore directly in conflict with the decision of the First Circuit, which reversed the Board of Tax Appeals.

II. THE COURT BELOW COULD NOT HAVE PROPERLY AND CORRECTLY CONSTRUED THE SCOPE OF THE COMMISSIONER'S DISCRETION IN DETERMINING WHAT CONSTITUTES A "REASONABLE" ADDITION TO A BAD DEBT RESERVE BECAUSE THE COURT DECISIONS CONSTRUING § 166(c), INTERNAL REVENUE CODE, ARE SO DIVERSE AS TO RENDER THE STATUTE MEANINGLESS.

Aside from stating that the addition to a bad debt reserve account must be "reasonable" and for a few generalized comments on "reasonableness" (at § 1.166-4(b) of the Commissioner's Regulations [1]), neither

[1] This Section of the Regulations provides as follows:

"(b) Reasonableness of addition to reserve.—(1) Relevant factors.—What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior years, and the total amount of the existing reserve."

the Internal Revenue Code nor the Regulations thereunder provide much in the way of useful information on just what is reasonable. This has left the Internal Revenue Service free to inject its own formulae for determining reasonableness; and, in addition to the fact that such formulae have varied from case to case throughout the years, the court rulings on whether or not the bad debt reserves of particular taxpayers were reasonable have been inconsistent to the point of creating chaos in the area.

For example, the Tax Court in *Industrial Credit Co., Inc.*, T.C. Memo. Dec. 1967-75, P-H TC Memo ¶ 67,075 (1967), found as reasonable the bad debt reserves claimed by the petitioner therein based upon the facts that said petitioner was engaged in a high risk financing business, it had not had sufficient time in which to develop a history of actual bad debts, it had operated only in a healthy economy with a high level business cycle, and comparable lending institutions having less risk are allowed a larger percentage than said petitioner claimed. However, the same court, in *Commercial Capital Corporation*, T.C. Memo. Dec. 1968-186, P-H TC Memo ¶ 68,186 (1968), upheld the Commissioner of Internal Revenue when he relied upon the sole factor of the taxpayer's bad debt history in disallowing a deduction for additions to its reserve for bad debts. The Tax Court again allowed the Commissioner to prevail in *Massachusetts Business Development Corp.*, 52 T.C. 946 (1969) when he relied primarily on that taxpayer's past loss history, even when that taxpayer was engaged in high risk financing and had been in business only a short time. In addition, the factor of economic prosperity and possible future depression was specifically excluded from con-

sideration because, said the court, to permit an accumulation for this reason constituted nothing more than a "contingency reserve against excessive losses in possible future depression years—a type of reserve that might be justified by sound business reasons but not one that is within the contemplation of section 166(c)." 52 T.C. at 955. Support for this theory was found in such cases as *American State Bank* v. *United States*, 279 F.2d 585 (7th Cir. 1960) and *S. W. Coe & Co.* v. *Dallman*, 216 F.2d 566 (7th Cir. 1954).

Opposing the view that the establishment of a reserve for future contingencies is not deductible (in addition to *Industrial Credit Co., Inc.*, supra) are *Mitchell-Huron Production Credit Association* v. *Welsh*, 163 F.Supp. 883 (D.S.D. 1958), *Bolling* v. *Commissioner*, supra, *Rhode Island Hospital Trust Company* v. *Commissioner*, supra, and *Union National Bank of Youngstown* v. *United States*, 237 F.Supp. 753 (N.D. Ohio 1965). In the latter case the Court stated:

> "The Commissioner has long been impressed with his caveat against the establishment of 'mere contingency' reserves, and, therefore, the thrust of his reasoning is diverted from a fundamental principal of taxation—that of providing, as far as possible, equal standards or measures for all who are similarly situated— . . .
>
> "The real question is not whether a fund for contingencies shall be allowed—all of these reserves contain contingency factors—but, the question must be whether the contingency factor shall be required to be uniform, i.e., measured with the same ruler." 273 F.Supp. at 763.

And, opposing the view that the use of a taxpayer's bad debt history as the sole basis for upholding a deter-

mination by the Commissioner (in addition to *Industrial Credit Co., Inc.*, supra) is *First Trust and Savings Bank of Davenport, Iowa* v. *United States*, 23 AFTR 2d 69-971 (S.D. Iowa, 1969), where the court held that the fact that there had been in the past no losses with respect to the loans for which the reserve had been established did not justify the conclusion that there was no reasonable risk of loss, or that such losses may not be reasonably anticipated to occur in the future in the ordinary course of the taxpayer's business. See also on remand to the Tax Court, *Glen L. Bolling*, T. C. Memo. Dec. 1966-216, P-H TC Memo ¶ 66,216.

Further, there is great diversity in the weight to be given testimony of individuals as to what would be a reasonable reserve for bad debts. This varies from "very substantial, if not controlling weight" in *Rhode Island Hospital Trust Company* v. *Commissioner*, supra, to "weight" in *Industrial Credit Co., Inc.*, supra, to such little weight that it did not rise to that level of proof which would show an abuse of discretion on the part of the Commissioner, *Patterson* v. *Pizitz, Inc.*, 353 F.2d 267 (5th Cir. 1965).

Likewise, the question of what constitutes a proper exercise of discretion by the Commissioner has varied from *Black Motor Co.*, 41 B.T.A. 300 (1940), Affd. 125 F.2d 977 (6th Cir. 1942), where such discretion was held to be properly exercised in the absence of a conclusive showing by the taxpayer that the Commissioner's computation was not reasonable, to *Industrial Credit Co., Inc.*, supra, where the submission of evidence attesting to the hazardous nature of the taxpayer's business was sufficient justification for the court to hold that the Commissioner's action in disallowing additions to bad debt reserves was arbitrary.

The result of such diverse and inconsistent authorities has been to confuse and cloud the true meaning and intent of Section 166(c), Internal Revenue Code, and has the ultimate effect of permitting a court to arbitrarily select the result it wishes to reach in a particular case and then substantiate such result by citing the authorities which support its decision while simply ignoring those cases not consistent therewith.

III. THE COURT BELOW, IN DECIDING THAT THE RESPONDENT'S MOTION TO SET ASIDE THE JURY'S VERDICT IN FAVOR OF THE PETITIONER SHOULD HAVE BEEN GRANTED MERELY SUBSTITUTED ITS DECISION FOR THAT OF THE JURY AND THEREBY DENIED THE PETITIONER OF ITS RIGHT TO TRIAL BY JURY IN VIOLATION OF AMENDMENT VII, UNITED STATES CONSTITUTION.

The Seventh Amendment prohibits re-examination, by any Court of the United States, of any fact tried by a jury except in accordance with the rules of the common law; and an appellate court cannot substitute its judgment for that of the jury. *Smith* v. *Illinois Central Railroad Company*, 394 F.2d 254 (6th Cir. 1968). The focal point of judicial review is the reasonableness of the particular inference or conclusion drawn by the jury, *Tennant* v. *Peoria & P.U. Ry. Co.*, 321 U.S. 29, 64 S.Ct. 409, 88 L.Ed. 520 (1944); and a jury verdict should never be pre-emped by the court unless it has no basis in fact. *Compton* v. *United States*, 377 F.2d 408 (8th Cir. 1967).

A motion to set aside the jury's verdict cannot be granted unless "*as a matter of law*, the opponent of the movant failed to make a case, and, therefore, a verdict in movant's favor should have been directed," *Montgomery Ward & Co.* v. *Duncan*, 311 U.S. 243, at 251, 61 S.Ct. 189 at 194, 85 L.Ed. 147 at —— (1940). (Italics added). In addition, the evidence must be con-

sidered in the light most favorable to the party against whom the motion is directed; and every conclusion or inference that can be legitimately drawn therefrom in its behalf must be drawn. *Burcham* v. *J. P. Stevens & Co., Inc.*, 209 F.2d 35 (4th Cir. 1954).

The court below held that it was its duty to withdraw the present case from the jury because the necessary inference was so tenuous that it rested merely upon speculation and conjecture. (Appendix 7a).

The witnesses for BDC included its Executive Vice President, three members of its Executive Committee, the Executive Vice President of the Business Development Corporation of New York, the Executive Vice President of RDIC Development Corporation (Pennsylvania's equivalent of a business development corporation), the Commissioner of Banks of the State of North Carolina, and a member of BDC's Board of Directors who was also a former governor of North Carolina and former Secretary of Commerce of the United States.

The evidence presented by these witnesses established prima facie that BDC's loans were risky and speculative; that its average loan was substantial in amount; that all of its loans were repayable on a long-term basis (10 to 15 years); that it was engaged in a new type of business and was one of the first of its type to commence operations; that up to the end of the last taxable year in controversy it had operated in an ascending economy and under good business conditions; that as of the end of each year in controversy and after the additions to its reserve, the amount of the taxpayer's reserve, was between two to two and one-half times the amount of its average outstanding loan; that

if no addition had been made to the reserve, the amount of the taxpayer's reserve at the end of each year in controversy would have been less than twice the amount of its average outstanding loan; that as of the end of each year in controversy the taxpayer had not operated through one complete cycle of its loans; that during each year in controversy the taxpayer incurred a substantial loss by reason of a defaulted loan or loans; and that its directors (all of whom were prominent businessmen who served without compensation as a public service), the Commissioner of Banks, and officials of corporations engaged in the same type of business in other states considered its reserve (including the additions) to be reasonable and the reserve, as allowed by the Commissioner, to be too low and inadequate.

While it is true that only one witness testified as to specific loans, that would be sufficient to warrant submitting the case to the jury, inasmuch as it does present some evidence for the petitioner. However, the individuals concerned with the establishment of BDC's reserves for the years in question were experienced bankers and businessmen, and they gave sound testimony as to their reasons for establishing the reserve at the level set forth above.

In light of the evidence presented and the calibre of BDC's witnesses, for the Fourth Circuit to say that there was "no substantial evidence to support" the jury's verdict and that the inferences raised thereby were "so tenuous as to rest merely upon speculation and conjecture" is tantamount to depriving BDC of its constitutional right to a jury trial. Such result is made all the more obvious by the Court's utter disregard of precedents laid down with respect to the weight

to be given to such testimony in *Rhode Island Hospital Trust Company* v. *Commissioner,* supra; *Bolling* v. *Commissioner,* supra; and *Industrial Credit Co., Inc.;* supra.

IV. THE COURT BELOW, IN APPROVING THE DETERMINATION OF THE COMMISSIONER OF INTERNAL REVENUE THAT THE PETITIONER WAS NOT ENTITLED TO DEDUCTIONS FOR THE ADDITIONS MADE TO ITS RESERVE FOR BAD DEBTS IN 1963 AND 1964, APPROVED AN EXERCISE OF DISCRETION BY THE COMMISSIONER WHICH RESULTS IN A DOUBLE STANDARD FOR SIMILARLY SITUATED TAXPAYERS.

The applicable statute, Section 166(c), Internal Revenue Code, authorizes the Commissioner of Internal Revenue to exercise his discretion in determining the reasonableness of an amount added to a reserve for bad debts. In certain instances he has exercised this discretion by the issuance of Revenue Rulings establishing guidelines as to what constitutes a reasonable reserve for bad debts in a particular industry.

For example in Revenue Ruling 65-92, 1956-1 C.B. 112, he approved the utilization by commercial banks of a uniform reserve ratio of 2.4% of outstanding loans as a reasonable reserve. For years prior to the issuance of this Ruling, banks were authorized by Mimeograph 6209, 1947-2 C.B. 26, as supplemented by Revenue Ruling 54-148, 1954-1 C.B. 60, to establish a reserve for bad debts based upon an average experience ratio compiled over any 20 consecutive years after 1927, which period could be so constructed as to include the 1929-1930 depression period.

Another example of the Commissioner's exercise of discretion by the establishment of guidelines is found in Revenue Ruling 64-48, 1964-1 (Part 1) C.B. 104,

as clarified by Revenue Ruling 65-88, 1965-1 C.B. 112, where he authorized Small Business Investment Corporations (SBIC's) to establish a reserve for bad debts equal to 10% of their outstanding loans receivable. This Ruling was based upon the premise that SBIC's constitute a new industry and have only been in existence since 1959, an insufficient number of years to compile an adequate loss experience. It does provide that after a particular SBIC has been in existence for more than ten years it must use its own experience in making additions to its reserve for bad debts; however, it may maintain a reserve equal to 10% of its outstanding accounts receivable for the first ten years of its existence.

Although SBIC's are federally chartered organizations, they serve the same function as the state chartered business development corporations and are quite similar in nature and operation. However, the Commissioner has refused to apply Revenue Ruling 64-48 (as clarified by Revenue Ruling 65-88) to them or issue a similar ruling which would apply to business development companies. Instead he has attacked as unreasonable the additions made to BDC's reserve for bad debts during the seventh and eighth years of its existence in amounts sufficient to maintain such reserves at between 4% and 5% of its outstanding loans receivable at the end of each of such years.

There is no justification whatsoever for applying a less favorable standard to state chartered business development corporations than that applicable to federally chartered SBIC's. This unequal treatment constitutes arbitrariness *per se* by the Commissioner and results in discrimination against the petitioner herein. *Union National Bank of Youngstown* v. *United States*,

supra. See also *Industrial Credit Co., Inc.*, supra, where the Tax Court spoke to this precise point:

> "Thus, with one hand, the Commissioner has recognized the inherent risk to Intermountain Capital [a SBIC] and allowed it a 10 percent reserve for bad debts until it has a 10 year loss experience and with the other hand, he has refused to recognize the same risk facing the petitioner, which is engaged in the same type of business as Intermountain Capital. We think the difference in treatment is not justified". P-H TC Memo ¶ 67,075 at page 418.

V. IN DETERMINING WHAT CONSTITUTES A REASONABLE ADDITION TO THE RESERVE FOR BAD DEBTS OF A TAXPAYER ENGAGED IN A NEW TYPE OF BUSINESS WITH NO ACTUAL PAST EXPERIENCE, THE LIMITATION OF CONSIDERATION TO THE PAST LOSS RECORD OF SAID BUSINESS TO THE EXCLUSION OF OTHER FACTORS, RESULTS IN A GROSS MISCARRIAGE OF JUSTICE.

The case of *Black Motor Co.*, 41 B.T.A. 300 (1940), affd. 125 F.2d 977 (6th Cir. 1942), is the case to which many courts have turned for direction in determining whether or not bad debt reserves were reasonable. The formula approved by that case consisted of obtaining a six year ratio of average net charge-offs to outstanding receivables at year end and then applying such ratio to the outstanding receivables at the end of the year being examined. It was upon this formula that the Revenue Agent auditing BDC's books and records, and consequently the Commissioner of Internal Revenue, relied on making his determination that the additions to its reserve for bad debts were excessive and unreasonable; and the ultimate determination by the court below that the Commissioner's action was not shown to be arbitrary resulted in the approval of the use of said formula in the present case.

However, the formula approved in *Black Motor Co.* takes into consideration only past events to the exclusion of what may occur in the future. Moreover, the formula presumes that (1) the taxpayer has been in operation long enough to establish a reasonable experience factor and (2) the taxpayer's losses occur on receivables created primarily in the same year in which the loss occurs; neither of which is the situation in the present case.

Therefore, the strict reliance upon such a formula has resulted in a gross miscarriage of justice by denying BDC the right to have its case decided upon the basis of rules of law which apply to its factual situation.

Here, BDC, engaged in a new type of business, had been in operation for only a few years, had made relatively few large speculative long-term loans, and had not been in existence for one complete cycle of its loans. How, then can the same formula be applied as was applied to a taxpayer which acquired trade receivables in the ordinary course of its business and which had operated for a period sufficient to establish a meaningful loss experience?

CONCLUSION

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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